Internal Revenue Service

memorandum

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to: Paul Tew, International Examiner, Greensboro, NC

from: Chief, Branch 5, Office of Associate Chief Counsel (International) Robert Katcher

subject: [redacted]

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This memorandum responds to your request for informal assistance on the examination of [redacted] (Taxpayer). You request our assistance on the application of the tax benefit rule to the reduction in certain insurance reserves held by Taxpayer and whether those amounts can be excluded from income because their deduction in previous years did not produce a tax benefit. Taxpayer argues that because the reserve reductions were attributable to foreign source risks the amount of the reductions should not be includible in U.S. taxable income. Taxpayer also argues, however, that the premium income cannot be traced because of the nature of the reinsurance transactions, and therefore cannot be included in U.S. taxable income.

CONCLUSION

The reductions in reserves cannot be excluded from income under the tax benefit rule. In Allstate Insurance Company v. U.S., 20 Cls.Ct. 308 (1990), 1990-1 USTC P50,241, the Claims Court followed the 7th Circuit's decision in Home Mutual Insurance Co. v. Commissioner, 80-1 USTC P9392, aff'd en banc 639 F.2d 333 (7th Cir. 1980), 81-1 USTC P9127, cert. denied 451 U.S. 1017, and held that taxpayer could not receive the benefits of the exclusionary aspect of the tax benefit rule where the inclusionary aspect of the rule had not been invoked. In the present case, as in Allstate and Home Mutual, the amounts to be included in income, i.e., reductions in reserves, are decreases in the total losses incurred deduction under §832(b)(5) of the Code and therefore are not separate items of income includible under the tax benefit rule.

To the extent Taxpayer can demonstrate to the satisfaction of the District Director that the initial reserve deductions would have been allocated and apportioned to non-effectively connected foreign source income, it may be reasonable to conclude that income resulting from a subsequent reduction in related reserves would properly be characterized as non-effectively connected foreign source income.

FACTS

Taxpayer is a property and casualty insurance company domiciled in [redacted]. Taxpayer participates in reinsurance contracts through [redacted], a domestic corporation. [redacted] represents various insurance companies in the procurement, underwriting, and servicing of reinsurance contracts. We understand there are issues in this examination regarding whether or not Taxpayer's contacts with [redacted] rise to the level of establishing a permanent establishment for U.S. tax purposes. This memorandum does not address those issues.

Taxpayer has filed tax returns for an "official" U.S. branch[1] and has filed protective returns on the [redacted] transactions, but asserts that any income derived from its contract with [redacted] is not associated with a permanent establishment and therefore not subject to U.S. taxation.

Taxpayer included quarterly and annual statements from [redacted] with its protective returns. Those statements itemize reserve and loss accounts for Taxpayer and adjustments made to the reserve and loss accounts. Taxpayer did not report certain reserve reduction amounts itemized on the [redacted] statements on the protective returns. Taxpayer asserts that those reserve reduction amounts are attributable to reinsurance contracts that represent foreign source risks and therefore, had Taxpayer filed U.S. income tax returns (which it did not do) for the years in which additions were made to the reserves, the deduction created thereby would have been only allocable to foreign source income and Taxpayer would not have received a U.S. tax benefit from those deductions. Taxpayer argues therefore, the reductions in those reserves are not includible in the Taxpayer's U.S.

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[1]Taxpayer concedes it has a branch for other business, but argues that the reinsurance underwritten through [redacted] is non-effectively connected income and not subject to U.S. taxation.

taxable income. Taxpayer cites the tax benefit rule for this position.

DISCUSSION

The tax benefit rule is a judicially developed principle that attempts to work a compromise between measuring income under an annual accounting system as employed by the federal income tax system, and under a transactional methodology. See Hillsboro National Bank v. Commissioner, 460 U.S. 370, 381 (1982), on remand Bliss Dairy, Inc. v. United States, 704 F.2d 1167 (9th Cir. 1983). The tax benefit rule itself has two aspects: inclusion and exclusion. The inclusionary aspect requires the inclusion in income of amounts previously deducted, and which were subsequently recovered. William H. Block, 39 B.T.A. 338 (1939), aff'd sub nom. 111 F.2d 60 (7th Cir. 1940), cert. denied 311 U.S. 658 (1940). The exclusionary aspect provides that that portion of a recovery not resulting in a prior tax benefit can be excluded from income. Home Mutual Insurance Co. and Allstate Insurance Co. v. U.S.

In Home Mutual, the taxpayer sought to make opening year adjustments to its unpaid loss accounts by the amount by which pre-1963 claims settled during the year had been overestimated in the unpaid loss account. Prior to 1963, mutual insurance companies were taxed under a formula that did not include any deduction for underwriting losses, rather, unpaid loss accounts reduced underwriting income. Thus, amounts a mutual insurer added to its unpaid loss account did not create deductions from taxable income. The Revenue Act of 1962 changed the taxation of mutual insurers however, taxing them for the first time on underwriting income or loss.

The unpaid loss account works in this manner: an insurer underwrites a contract on which a claim is filed in 1963, and the insurer estimates the claim to be worth $10,000. That $10,000 is added to the unpaid losses account. This unpaid loss account increased the losses-incurred deduction from premiums earned to arrive at underwriting income, thus conferring a tax benefit for that year. The claim is settled in 1965. If the amount of the settlement is $10,000, that amount is removed from the unpaid loss account (reducing the losses-incurred deduction for that year) and paid out (a deduction for actual losses paid) for a practical wash of inclusion and deduction, so no further tax consequences. If, however, the claim is settled for $8,000, there are tax consequences in 1965 because as the $10,000 is removed from the unpaid loss account, reducing the losses-incurred

deduction, there is an "offsetting" actual loss incurred deduction of only $8,000, resulting in a net $2,000 of ordinary income to the insurer. Under the pre-1962 tax scheme, Home Mutual received no tax benefit from overestimating its unpaid loss account but received a $2,000 increase in taxable income when the actual claim was paid in 1965.

Home Mutual argued that because it received no tax benefit, there should be no inclusion in income of the full amount of the reduction in the unpaid loss account when actual claims were paid. The Seventh Circuit examined the statute and found no authority for the adjustment Home Mutual urged. Nor was the court persuaded by an argument analogizing the unpaid loss account to inventories or bad debt reserves. The court then examined the tax benefit rule, its history, and its application, and concluded that the historical origin of the rule requires the use of the inclusionary aspect of the rule before a taxpayer can employ the exclusionary aspect. The court then noted that the inclusionary aspect did not come into play on the facts presented by Home Mutual:

> "Recoveries" of the amounts of overestimates of actual liability on unpaid loss accounts are taxed not by operation of the tax benefit rule to make such recoveries items of gross income under section 61(a), but by the specific terms of a detailed statutory mechanism, which requires downward adjustment of a taxpayer's unpaid losses outstanding at the end of the year during which the claim is actually paid by the amount of the original estimate.

639 F.2d at 346.

In so holding the court distinguished American Financial Corp. v. Commissioner, 72 T.C. 506 (1979) (exclusionary aspect of tax benefit rule applied to the treatment of salvage and reinsurance recoverable).

The Claims Court in the Allstate case cite Home Mutual favorably and dismisses American Financial as unpersuasive:

> However, unlike the Tax Court in American Financial, this court does not have the option of taking this "critical step" and ignoring the "technical niceties" of the tax statutes here, since we are bound by several Court of Claims decisions which read section 832 and the applicable Treasury Regulations as directing the treatment of subrogated recoveries, along with "unpaid

> losses", as independent components that together formulate the "losses incurred" deduction. [citation omitted.] This treatment by the Court of Claims is necessarily inconsistent with plaintiff's tax benefit claim as supported by American Financial.

20 Cls.Ct. at 315.

Like Home Mutual, Taxpayer has taxable years in which unpaid loss accounts are reduced which in turn results in a reduction of the losses incurred deduction under §832(b)(5). Like Home Mutual, Taxpayer received no tax benefit from the original additions to the unpaid loss accounts.[2] Taxpayer does add a new wrinkle to the facts however; Taxpayer argues that its reductions in unpaid loss accounts are attributable to foreign risks.

To sustain this position however, Taxpayer must demonstrate that the losses incurred deduction would have been properly allocated and apportioned under §1.861-8 of the regulations to foreign source income. Taxpayer also argues however, that because the "vast majority" of its reinsurance business through [redacted] is excess loss reinsurance,[3] it cannot source its reinsurance premium income. (Taxpayer's memorandum dated [redacted] to Mr. Paul Tew, I.E.) Taxpayer does concede that a look-through approach is appropriate for pro rata forms of reinsurance, but would have the Service exclude the bulk of its premium income as foreign source. Taxpayer cannot have it both ways. Either the premiums and insurance deductions (i.e., unpaid loss accounts and unearned premiums reserves and incurred but not reported

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[2]Not because of a change in the tax law, but because [redacted] failed to file U.S. federal income tax returns for those years.

[3]Briefly, excess loss reinsurance is a form of indemnity reinsurance whereby the reinsurer agrees to indemnify the ceding company (the direct underwriter of insurance) for a certain percentage of a particular line of insurance business, or a particular body of contracts. Taxpayer argues that because excess loss reinsurance can represent a percentage of the ceding company's liability rather than particular contracts, the practical and economic implications of tracing for source purposes preclude application of section 861(a)(7). Taxpayer argues that the situs of the ceding company should determine sourcing for excess loss reinsurance.

loss accounts) can be traced and sourced, or neither the premiums nor insurance deductions can be traced and sourced.

It is true that sourcing excess loss reinsurance premiums is difficult. However, to allow reinsurers generally to source risks by the situs of the ceding company is readily subject to abuse. For example, this rule would allow any reinsurer to only reinsure through non-U.S. insurers and treat the income from those reinsurance transactions as foreign source regardless of the actual source of the risk. Such a source rule would also eliminate any liability for the premium excise tax under §4371 of the Code which imposes an excise tax on every premium, direct or reinsurance, attributable to a U.S. risk.

Taxpayer must demonstrate to the satisfaction of the District Director the extent to which the reserve reduction amounts would have been properly allocated and apportioned to foreign source non-effectively connected income (i.e., income in connection with foreign risks). This is generally addressed on a facts and circumstances basis. See generally §1.861-8(b) and (c). One method you might consider would be to ask the Taxpayer to request from the ceding company an analysis of the situs of risks for the line of business being ceded and use those figures (e.g., 50% U.S. risks, 50% non-U.S. risks) to arrive at an allocation of premium income commensurate with the direct insurers business. To the extent Taxpayer so demonstrates, any subsequent income inclusion related to those amounts would be characterized as non-effectively connected foreign source income. However, as indicated, it appears to us that Taxpayer has failed to demonstrate that treating the inclusion as foreign source is appropriate.

The Supreme Court in Hillsboro posited that "the tax benefit rule must be applied on a case-by-case basis. A court must consider the facts and circumstances of each case in the light of the purpose and function of the provision granting the deductions." 460 U.S. at 385. As the Claims Court stated in Allstate: "the relevant sections of the tax code have been designed in response to insurance companies' accounting needs; . . . . This court declines to disturb this relationship, designed by Congress, between the 'losses paid' and the 'unpaid losses' components of the 'losses incurred' deduction." 90-1 USTC at 83,868.